No. 85-1727

Supreme Court, U.S.
FILED
JUL 17 1986
JOSEPH F. SPANIOL, JR.
CLERK

# In the Supreme Court of the United States

OCTOBER TERM, 1986

H. FLOYD SHERROD, JR., AND ESTALEE SHERROD SANDLIN, CO-EXECUTORS OF THE ESTATE OF H. FLOYD SHERROD,
PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT*

## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
*Solicitor General*
*Department of Justice*
*Washington, D.C. 20530*
*(202) 633-2217*

12 pp

## TABLE OF AUTHORITIES


Page

Cases:

*Martin* v. *Commissioner*, 783 F.2d 81 ..... 5

*National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472 ..... 7

*Schuneman* v. *United States*, 783 F.2d 694 ..... 5, 7

*United States* v. *Cartwright*, 411 U.S. 546 ..... 7

Statutes and regulation:

Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421(b)(1), 95 Stat. 306 ..... 6

Internal Revenue Code (26 U.S.C.):

§ 2032A (1976 ed.) ..... 1, 2, 6

§ 2032A ..... 1, 2, 6

§ 2032A(b)(1) ..... 5

§ 2032A(b)(1)(A) (1976 ed.) ..... 5

§ 2032A(b)(1)(A) ..... 2, 3

§ 2032A(b)(1)(A)(i) ..... 7

§ 2032A(b)(1)(B) ..... 7

§ 2032A(b)(2) ..... 3

§ 2032A(b)(1)(C) ..... 7

§ 2032A(e)(7) ..... 2

Page

Statutes and regulation—Continued:

Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003(a), 90 Stat. 1856 ..... 2

Treas. Reg. § 20.2032A-3(b)(1) ..... 7

Miscellaneous:

H.R. Rep. 94-1380, 94th Cong., 2d Sess. (1976) ..... 2, 5

H.R. Rep. 97-201, 97th Cong., 1st Sess. (1981) ..... 6, 9

S. Rep. 97-144, 97th Cong., 1st Sess. (1981) ..... 6

# In the Supreme Court of the United States

OCTOBER TERM, 1986

---

No. 85-1727

H. FLOYD SHERROD, JR., AND ESTALEE SHERROD SANDLIN, CO-EXECUTORS OF THE ESTATE OF H. FLOYD SHERROD, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT*

---

**MEMORANDUM FOR THE RESPONDENT IN OPPOSITION**

---

Petitioners contend that the decedent's lease of farmland to an unrelated party for a fixed rental constituted a "qualified use by the decedent" within the meaning of Section 2032A of the Internal Revenue Code,[1] thereby making the land eligible for "special use" valuation for federal estate tax purposes under that section. This contention was correctly rejected by the court of appeals, and there is no conflict among the circuits or other consideration warranting further review.

---

[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

1. Property ordinarily is valued for federal estate tax purposes at its fair market value on the date of the decedent's death. This standard takes into account the property's "highest and best use," whether actual or potential. Congress became concerned that in some cases valuation of farmland at its highest and best use, such as for real estate development, produced such a large estate tax liability that the heirs of family farms had to liquidate the farms in order to pay the tax. See H.R. Rep. 94-1380, 94th Cong., 2d Sess. 21-22 (1976). Accordingly, to "encourage the continued use of property for farming and other small business purposes" (*ibid.*), Congress in 1976 enacted Section 2032A of the Code. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003(a), 90 Stat. 1856. That section permits qualifying real estate to be valued for estate tax purposes based on its actual use, rather than on the basis of its highest and best use. See I.R.C. § 2032A(e)(7).[2] This "actual use" valuation can reduce estate tax liability considerably, because it enables the executor to look primarily to the current return, which in the case of working family farms will often be relatively low, rather than to the investment value of the land.

Congress established several prerequisites to qualify for special use valuation. The condition relevant to this case is that at least 50% (in terms of fair market value) of the adjusted gross estate must consist of property "which * * * on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family" (I.R.C. § 2032A(b)(1)(A)).[3] The statute

---

[2]As a general rule, this is done by capitalizing earnings that the existing business can be expected to yield.

[3]The phrase "by the decedent or a member of the decedent's family" was added to the statute in 1981, but made retroactively applicable to estates of decedents dying after December 31, 1976. See pages 5-6, *infra*.

defines "qualified use" as "the devotion of the property to any of the following: (A) use as a farm for farming purposes, or (B) use in a trade or business other than the trade or business of farming." I.R.C. § 2032A(b)(2). If an estate fails this 50 percent test, none of its assets are eligible for special use valuation.

2. Petitioners are co-executors of the estate of H. Floyd Sherrod, who died in 1977. His gross estate contained three distinct tracts of land totalling 1,478 acres, which consisted of timber land, crop land, and pasture land. The decedent and his son carried on a tree-farming business on the timber land. But neither the decedent nor anyone else in the family conducted any farming activities on the rest of the land. At the time of the decedent's death, and for some years before, the crop land and part of the pasture land were leased to non-family members for farming purposes. The tenants paid fixed cash rentals, rather than rent linked to the production of the land. Pet. App. 2a-4a, 13a.

On the estate tax return, petitioners claimed Section 2032A special use valuation, which was well below fair market value, for the 1,478 acres. On audit, the Commissioner disallowed that claim, computed the estate tax based on the fair market value of the property, and asserted a deficiency in estate tax. Petitioners challenged this determination in the Tax Court. Pet. App. 4a-5a.

3. a. The Tax Court held for the estate (Pet. App. 23a-41a). The court first determined that the decedent and his son put the timber land to a "qualified use" in an active timber farming business of their own (*id.* at 37a). That determination did not end the matter, however, because the fair market value of the timber land amounted to only 26% of the adjusted gross estate, well short of the 50% needed to satisfy Section 2032A(b)(1)(A). See Pet. App. 13a. The Tax Court went on to rule that the rest of the land was also

devoted to a "qualified use"—putting the estate over the 50 percent threshold—on the theory that the non-timber land constituted "an aid to" and "an integral part of" the timber land (*id.* at 37a-38a).

b. The court of appeals reversed (Pet. App. 1a-21a). The court agreed with the Tax Court that the decedent and his son conducted an active farm business on the timber land that met the "qualified use" requirement (*id.* at 12a). The court of appeals concluded, however, that the decedent's other land holdings did not meet that requirement. The court explained that the crop and pasture lands "d[id] not themselves fall within the qualified use category" (*id.* at 13a) and that they had no "discernible relationship, functional or otherwise," to his timber land (other than the fact of common ownership) (*id.* at 20a-21a). In contrast to the timber land, the court found, the crop and pasture land "was not employed in an active trade or business of the decedent or of a member of his family as is called for in the statute" (*id.* at 13a), and the decedent's sole involvement in the farming of the rented property was as "a landlord passively collecting a fixed rental from an unrelated party" (*id.* at 15a). The court further explained that it was "irrelevant" that the "unrelated" tenants ran a farm on the land they rented from the decedent (*id.* at 14a): "For the purposes of 'qualified use' inquiry, it does not matter to what use a tenant put the land; the focus is on what the decedent did with the land."

4. The decision below is correct. Petitioners contend (Pet. 5-11) that the rented land satisfied the "qualified use" test because it was used for farming. They submit that it makes no difference under the qualified use test that the land was farmed by unrelated parties and that the lease payments were not keyed to production. This contention is belied by the language of the statute, which states that property can qualify for special use valuation only if it "was being used for a qualified use *by the decedent or a member*

*of the decedent's family*" (I.R.C. § 2032A(b)(1) (emphasis added)). Petitioners totally ignore this language, which is flatly inconsistent with their submission. Moreover, the decision below, which accords with the other court of appeals' decisions on this issue (see *Martin* v. *Commissioner*, 783 F. 2d 81 (7th Cir. 1986); *Schuneman* v. *United States*, 783 F. 2d 694, 695 n.1, 698-699 & n.2 (7th Cir. 1986)), is further suppported by the policy of the statute, the legislative history, and the relevant Treasury regulations.

a. As originally enacted in 1976, Section 2032A granted special use valuation for property which, "on the date of the decedent's death, was being used for a qualified use" (26 U.S.C. (1976 ed.) 2032A(b)(1)(A)). The phrase "by the decedent or a member of the decedent's family" did not then appear in the statute. Even at that time, however, the legislative history of the 1976 Act made it clear that Congress intended to provide the preferential valuation only for land on which a decedent or a family member himself runs a farm, as distinguished from land on which an unrelated tenant runs a farm under a fixed rental arrangement with the decedent. The House report recited that "there must be a trade or business use," and that "[t]he mere passive rental of property will not qualify." H.R. Rep. 94-1380, *supra*, at 23. The report then continued as follows (*ibid.*):

> However, where a related party leases the property and conducts farming or other business activities on the property, the real property may qualify for special use valuation. For example, if A, the decedent, owned real property which he leased for use as a farm to the ABC partnership in which he and his sons B and C each had a one-third interest in profits and capital, the real property could qualify for special use valuation.

Thus, the 1976 legislative history strongly evidences Congress's intent that a farming lease to an outsider that does not grant the decedent's family an interest in the profits of

the underlying business falls outside the category of uses that qualify for special estate tax treatment.

This conclusion is confirmed by Congress's subsequent action with respect to the language of the statute. In 1981, Congress added the words "by the decedent or a member of the decedent's family" after the term "qualified use." Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421(b)(1), 95 Stat. 306. Because this amendment was "primarily technical" (H.R. Rep. 97-201, 97th Cong., 1st Sess. 178 (1981)), it was made retroactive to the estates of decedents dying after December 31, 1976, the effective date of the 1976 legislation, and thus applies to the estate here. In enacting this amendment Congress reiterated that a fixed rental lease to an unrelated party does not satisfy the "qualified use" requirement of the statute. The House and Senate reports both state that "[t]he bill does not change the requirement of present law that [a qualified use] be an active trade or business use, as opposed to a passive, or investment use." H.R. Rep. 97-201, *supra*. at 169; see S. Rep. 97-144, 97th Cong., 1st Sess. 133 (1981). The Senate report then explained the distinction in detail (*ibid.* (footnote omitted)):

> For example, if a decedent has leased otherwise qualified real property to a son pursuant to a net cash lease, and the son conducts a farming operation on the property, the son's business use is attributed under the bill to the decedent for purposes of satisfying the qualified use requirement (sec. 2032A(b)(1)). On the other hand, during any period when the decedent leases the real property to a nonfamily member for use in a qualified use pursuant to a lease under which the rental is not substantially dependent upon production, the qualified use requirement is not satisfied.

Thus, there can be little doubt that Congress did not intend to confer the benefits of Section 2032A special use valuation

on estates like the one in this case, where the family has no substantial involvement in farming operations.

b. The applicable Treasury regulation is in accord with the terms of the statute and its legislative history. It provides that "[u]nder section 2032A, the term trade or business applies only to an active business such as * * * the raising of agricultural or horticultural commodities, as distinguished from passive investment activities." Treas. Reg. § 20.2032A-3(b)(1). The regulation specifies that "[t]he mere passive rental of property to a party other than a member of the decedent's family will not qualify." Rather, "[t]he decedent or a member of the decedent's family must own an equity interest in the farm operation." *Ibid.* Thus, the court of appeals' decision is strongly supported by the well established rule that interpretive rulings by the Treasury, "if found to 'implement the congressional mandate in some reasonable manner,' must be upheld." *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979) (quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973)).

5. Petitioners do not discuss the language of Section 2032A(b)(1)(A)(i) or the relevant regulation and legislative history. Instead they look to another portion of the statute, Section 2032A(b)(1)(B) and (C), and argue that the court of appeals' decision must be wrong because it makes the "material participation" in 25% of the estate requirement superfluous (see Pet. 9). Rather, petitioners maintain, this latter section contains the only statutory requirement of family participation in the qualified use and therefore the 50% requirement is satisfied as long as the land is used for farming, even if the family's participation at the time of death is no more than collecting a fixed rental for the land. This contention is plainly mistaken. First, Section 2032A(b)(1)(A)(i) explicitly requires family participation in the qualified use for purposes of the 50% test. Second, it is

manifestly untrue that the court of appeals' decision makes superfluous the "material participation" requirement of Subsections (B) and (C). Unlike the provision at issue here, which pertains only to the use of the land on the date of the decedent's death, those subsections establish a test directed at the use of the property over the previous eight years. Those subsections prevent the decedent from taking action just before his death in order to qualify for special use treatment and seek to ensure that only properties that have genuinely been established as family farms or businesses will receive that treatment. For example, a property that is converted to use as a family farm one year before the decedent's death may satisfy the 50% test of Subsection (A), but it will not satisfy the 25% test of Subsections (B) and (C)—which petitioners erroneously characterize as superfluous. The two tests are distinct and are directed at different possible problems.

Petitioners also suggest that the decision below is at odds with the policies of the statute because a decedent who in his last years is too infirm to "materially participate" in farming will be unable to qualify for special use valuation—a result that Congress assertedly never intended (see Pet. 12). The decision below has no such effect. As the court of appeals recognized (Pet. App. 13a-15a), a decedent who leases his land to a relative for farming purposes, or who owns a substantial equity or cropshare interest in his tenant's farming operation, will meet the test of "qualified use." See *Schuneman* v. *United States, supra*. Thus, the mere fact that the owner of farmland has become physically unable to farm it personally does not mean that he cannot take advantage of the special use provisions as long as a relative continues to farm the land or the owner retains a substantial financial stake in the farming operation. This is fully in accord with the policy of the statute, which is not to give a special tax break to all farmers, but rather is limited to

preserving "family farms" against the possibility of dissolution because of estate tax liability. In the words of the court of appeals (Pet. App. 13a), the 50% test "is intended to confine the statute's benefits to those estates which would in fact be likely to experience a genuine liquidity problem because a major part of the estate's assets is tied up in a farm or other closely-held family business." See H.R. Rep. 97-201, *supra*, at 168 (statute aimed at protecting "family owned and operated" businesses). The decision below is faithful to that policy; petitioner's expansive interpretation of the special use provisions would undermine it.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
*Solicitor General*

JULY 1986

DOJ-1986-07